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**Hand Delivered**

February 7, 2003

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DOCUMENT CONTROL

Joel H. Peck
Clerk of the State Corporation Commission
C/o Document Control Center
P.O. Box 2118
Richmond, VA 23218

Re: Case No. PUE-2002-00645
In the Matter Concerning the Provision of Default Service to Retail Customers Under the Provisions of the Virginia Electric Utility Restructuring Act

Dear Mr. Peck:

On December 23, 2002 the State Corporation Commission issued an Order Establishing Investigation into the design of default service. Enclosed are Strategic Energy's initial comments in this Case.

Cordially,

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Encl: Original and fifteen (15) copies

## Commonwealth of Virginia

### Before the
### State Corporation Commission

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| In the matter concerning the provision of default service to retail customers under the provision of the Virginia Electric Utility Restructuring Act | ) | Case No. PUE-2002-000645 |

# Initial Comments of Strategic Energy, LLC

## I. Introduction

Strategic Energy is a competitive retail provider reliably serving approximately 3000 MW of load in six states[1]. Strategic Energy is expanding into more states, and has an interest in offering energy and energy services to consumers in the Commonwealth of Virginia as soon as the market is viable. Strategic Energy's extensive experience in different state jurisdictions is that default service[2] program design is a critical determinant of the success of retail competition, and by extension the ability of consumers to become active market participants. Passive retail customers (i.e. price takers) will not provide the feedback necessary to discipline the wholesale market.

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[1] Registered as a competitive retail supplier in a total of twelve states.

[2] The regulated provision of power supply to customer that do not shop for power or do not have competitive offerings or who are returned to utility by their supplier is alternatively referred to as Standard Offer Service ("SOS"), Provider of Last Resort ("POLR") service and Supplier of Last Resort ("SOLR") service.

Different state jurisdictions with active retail competition and wholesale markets have implemented various Default Service models. Some of the models currently being used are 1) the incumbent utility as provider[3], 2) the incumbent utility finds third-party suppliers[4], 3) the state commission finds a third-party supplier[5], 4) the incumbent utility affiliate provides Default Service[6]. The exact nature of the procurement process is not critical. It is essential to successful electric competition that default service is procured and priced as a full retail service, and includes the full cost of service. Price caps, deferrals, cross-subsidization and cost shifting will distort consumer behavior and lead to less than optimal economic outcomes. Consumers are not served by paying stranded costs for utility restructuring, only to be denied the benefits of competition because the incumbents' costs of serving energy are embedded in distribution charges or other non-bypassable wires charges.

While is it likely that some form of Default Service will always be needed for certain customer classes, regardless of the robustness of competition, Default Service does not need to be a hindrance to open, non-discriminatory access. Properly designed, Default Service can both protect consumers and promote competition.

## II. Comments

Section 56-585 of the Virginia Electric Utility Restructuring Act directs the State Corporation Commission ("Commission") to develop one or more Default Service programs to be available in conjunction with the commencement of retail choice. The

[3] NY and Ohio
[4] Massachusetts and New Jersey
[5] Maine
[6] Small customer classes in Texas.

Act defines Default service as "service made available ... to retail customers who (i) do not affirmatively select a supplier, (ii) are unable to obtain service from an alternative supplier, or (iii) have contracted with an alternative supplier who fails to perform." As defined, the legislature intended Default Service to initially be both an emergency service for customers who are without supply, and an alternate form of service for customers that have not received competitive offers.

The Act further requires the Commission to periodically consider "whether there is a sufficient degree of competition such that the elimination of default service for particular customers... will not be contrary to the public interest." By this statement, the Act clearly contemplates that Default Service will be modified in response to the development of competition. Strategic Energy recommends that the Commission adopt a default service that follows principles of open, non-discriminatory access and full cost allocation. The Commission should also allow flexibility in default service design as competition evolves. Experience in other markets shows that large, more sophisticated customers, are early participants of retail choice and can help create the conditions that promote active retail competition for all consumers. Large and medium customers should be more quickly encouraged to find a competitive supplier, and the default service available to these customers should be designed accordingly.

## A. Effective Competition Requires Different Approaches with Large and Small Customers

The Commission should implement default service that takes into account the characteristics of the different customer classes, the state of the competitive market for those classes, and the business realities of providing competitive service to those classes. As competition evolves in Virginia default service can evolve from a first resort to a last resort service. For large and medium customers, default service can quickly become limited to an emergency or interim service. Strategic Energy recommends that the Commission procure default service for large and medium customers through short-term contracts[7] as these customers will have immediate opportunities to manage market volatility through supply contracts and demand response. Default service for Residential and small commercial customers may need to be procured through longer-term contracts until the retail markets fully develops.

In Maine, an early adopter of retail choice, the Maine Public Utility Commission ("MPUC") recently completed a study of Standard Offer[8], as stipulated in the state's enabling legislation for competition. The study concluded:

> "In market sectors where retail suppliers are providing options and reasonable prices for customers, standard offer service should not be just another supply option, but should serve as a last resort or contingency service. By its design, standard offer service in these sectors should encourage and sustain customer out-migration to the retail market. Standard offer prices should closely track changes in the wholesale market, and other features of its design, such as treatment of customer credit, should parallel the market as much as possible." – *Standard Offer Study and Recommendations Regarding Service After March 1, 2005. Maine Public Utility Commission, December 1, 2002.*

The MPUC reviewed the evidence and concluded that large and medium customers have choices. What they failed to fully review in their study was the cause of active competition in the Commercial and Industrial sectors. The acquisition costs of large and medium customer is relatively small. In addition, serving the large customer classes in

[7] Monthly or six-month variable contracts.
[8] The Maine standard offer service is comparable to the default service contemplated by the Virginia Electric Restructuring Act.

Maine entails a minimum of requirements and restrictions for retail suppliers. Therefore, the cost of supplying these customers is minimized and the market is active. The Commission needs to be cognizant of its own Rules for Governing Retail Access, that they do not inhibit competition to the point of making default service the only choice for customers – large and small. A specific example of a Commission rule that increases a supplier's cost to serve is the customer's 10-day right to rescind. This is not a cost-free benefit, as retail suppliers must price in the risk that a customer will exercise its option to rescind. The cost increase often will absorb any savings that the customer might have realized had the 10-day hold premium not been necessary.

### B. Default Service Must Include All Price Components.

It is fundamental that the price of default service must include the fully bundled costs of providing the generation service, separate from the distribution rate. Failure to include all costs in the avoidable portion of the customers' bill will ensure the competitive market will fail. Unlike some other issues related to default service, pricing issues apply uniformly across all customer classes. Designing default service so that the full, avoidable cost is reflected in the energy portion of the bill is critical for accurate cost comparisons.

The avoidable costs that must be in the default service price include:

- Energy, ancillary services and energy-related transmission costs
- Administrative costs
- Electric supply-related bad debt
- Electric supply-related customer service

- The full costs of price and volume risk
- The cost of reporting requirements
- Reliability-related costs
- Renewable Portfolio Standards compliance costs
- An allocation of billing costs
- An allocation of utility overheads (if the utility is the default service provider)
- The effects of locational marginal pricing ("LMP")[9]

Essentially, default service is a retail product and must be treated as such, regardless of whether it is being supplied by the incumbent utility, an affiliate, a third-party supplier or any other organization. If default service is not properly priced as a retail product then cost shifting will occur and limit consumers' ability to reduce their total energy bill.

### C. The Incumbent Utility Should Exit the Role of Default Service Provider in order for an Efficient Competitive Market to Develop.

It will be necessary for the utility to exit the role of default service provider as quickly as possible in order for an efficient competitive market to develop. When the monopoly delivery company serves as the default provider of a competitive service it distorts the marketplace and impedes the development of the competitive market. The utility, as distribution provider, must avoid conflicts of interest between serving its own load and competitors load. Only when the distribution utility no longer takes title to energy is it free of conflicts of interest. Default service should be supplied by third-party providers.

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[9] When applicable in the future.

While the barriers created by utility default service apply to all customer classes, many of them apply most acutely to small customers. It is expensive and inefficient to serve small numbers of customers. This is especially true for low usage customers.. Where the utility has been allocated all of the customers on default service, a competitive supplier must pick up customers one-by-one. This creates a very slow path to efficient scale. Several suppliers of small customers that have taken this path have gone bankrupt. Most have chosen simply to stay out of the market in states that retain the utility in the role of default service provider. A retail auction to provide default service to small customers[10] is one method to address this barrier because it would enable suppliers to pick up large numbers of customers in one block. This gives the supplier instant scale and enables efficient operations from day one.

### D. Default Service Must Represent a True Retail Product, not a Wholesale Product in Disguise.

To achieve the desired result, it is essential that the default procurement reflects the cost of true **retail** service – not a wholesale service in disguise. Characteristics of retail service include:

- **License:** Suppliers must be licensed, retail electric suppliers.
- **Customer Service:** Suppliers are responsible for all generation related customer service.
- **Load Serving Entity:** Suppliers are the load serving entity and have all wholesale supply obligations.

[10] Residential and small commercial (GS-1) customers, often referred to as "mass market" customers.

- **Retail Obligations:** Suppliers are responsible for retail supply obligations, including disclosure and reporting requirements.
- **Billing:** Billing becomes a supplier responsibility, which the supplier may itself perform, or contract with the utility to perform or with a third-party on the supplier's behalf.
- **End of the Term:** At the conclusion of the default service term, the default service supplier has the option of either offering to competitively supply the customers, or returning the customers to a new default procurement process.

If the third-party provider of default service is providing the wholesale power only, then the incumbent utility usually must provide all of the retail services. When that is the case, the costs of these retail services often are embedded in the distribution portion of the bill, reducing the savings to customers that shop, and crippling retail competition. To ensure costs are properly allocated, the default service provider must reimburse the provider of retail services (whether that is the incumbent utility or third party) and include those costs in the price of default service.

## III. Conclusion

Strategic Energy is a competitive retail supplier with experience in many jurisdictions, and is planning to enter the Virginia market as the Restructuring Act and the Commission have set a strong foundation for competition. As envisioned by Strategic Energy, default service is procured from a third-party supplier as a full retail service, except that the customer has not affirmatively chosen the default supplier and therefore is free to shop. Until a customer affirmatively chooses a supplier it should not be held to full contractual terms. Experience has shown that when default service and retail access programs are properly designed commercial and industrial customers quickly learned to take full advantage of their opportunity to switch. Therefore and correctly so, default service will become a last-resort service only for these customers.

Experience has also shown that there is limited volumetric risk for small customers initially as these customers are less likely to receive offers until the competitive retail market has developed for large and medium customers. Because of the differences in volumetric risk costs and longer time necessary for full robust competition to develop for these customers, the Commission could consider separate default procurements for these two customer classes. The Commission should not shy away from exposing large and medium customers to price volatility in default service. Options for these customers will exist, and all consumers will have an opportunity to benefit from competition as long as the costs of default service are fully avoidable.

Strategic Energy respectfully requests that the Commission consider adopting the foregoing recommendations.

Respectfully Submitted

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February 7, 2003